Report of the Technical Committee on BUSINESS TAXATION

Report in Brief

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The views and recommmendations put forward in this report are those of the Technical Committee on Business Taxation, and do not necessarily reflect the views of the Minister or Department of Finance.

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Introduction

The Technical Committee on Business Taxation was appointed by the Minister of Finance on March 6, 1996 to review taxes paid by Canadian business and recommend ways of improving the business tax system. Under our terms of reference, the Committee was asked to assess Canada's business tax structure with the following objectives:

- improving the tax system to promote job creation and economic growth in an open economy;
- simplifying the taxation of business income to facilitate compliance by taxpayers and administration by Revenue Canada; and
- enhancing fairness in the tax system by ensuring that all businesses share the cost of providing government services.

The Committee was asked to take into account the fiscal constraints faced by federal and provincial governments, as well as to consider the co-ordination of federal and provincial tax policies that apply to business and income derived from business.

Balancing Competing Objectives

The primary purpose of taxation, including business taxation, is to raise revenue for governments in order to finance public expenditures on goods and services and transfers to individuals. Canadians know that the taxes they pay reduce economic growth and job creation in the private sector. At the same time, they realize that they benefit from government programs and must be prepared to contribute to their cost. Canadians also have the right to expect that, given a certain level of revenue required by governments, the tax system should not unduly retard job creation and economic growth, should operate in a fair manner and be as easy to comply with as possible.

These important objectives – job creation and economic growth, fairness and simplification in the taxation of business and income derived from business – are frequently in conflict. In pursuit of the best business tax structure for Canada, it is important to find a balance among them.

The Role of Business Taxes in the Overall System

Businesses paid close to $85 billion in taxes in 1995, accounting for 30 percent of all taxes paid to all levels of governments in Canada. About one-quarter of business taxes take the form of corporate income tax and other profit-sensitive taxes, while three-quarters are in the form of profit-insensitive taxes such as capital, property, payroll, sales, excise and other taxes. In relation to the value of their economic activity, the amount of taxes businesses pay has increased fairly steadily since 1950. Further, a growing portion has been levied by provincial-local governments.

Businesses ultimately do not bear taxes – they simply pass them on to others – to customers in the form of higher prices, to suppliers and labour through lower costs and wages and to those who supply capital through lower returns. But because businesses organize so much of our economic activity, there are circumstances that require them to be taxed so that the overall tax system is more efficient, fairer and easier to administer. One of the primary roles of business taxation, and particularly of the corporate income tax, is to help ensure that all income of individuals is fully taxed, including corporate income accruing to their benefit. (In the absence of the corporate income tax, individuals could avoid or defer the payment of income tax by leaving income undistributed in corporations in which they are shareholders.) Further, given the importance of foreign ownership of capital in Canada, business taxation ensures that foreign investors contribute to Canada's public revenue requirements. It is also appropriate to tax businesses to recognize that they benefit from public goods and services such as infrastructure provided by governments.

Deficiencies in the Current Business Tax Structure

The Committee reviewed the impact of the current business tax structure on economic growth and job creation, fairness and compliance. This review led to the following conclusions about deficiencies in the corporate business tax structure.

High Corporate Income Tax Rates by International Standards

Canada's combined federal-provincial general corporate income tax rate, which averages 43 percent, is higher than the comparable rate in Canada's most important trading and investment partner, the United States, where the combined federal-state rate averages 39 percent (see Chart 1). The implications of the comparatively high corporate income tax rate in Canada are twofold:

- Higher corporate tax rates on non-manufacturing activities in Canada relative to the United States and some other countries have discouraged the location of business operations in Canada.
- Internationally non-competitive tax rates have influenced large multinationals to increase borrowings in Canada and therefore interest expense deducted here. The resulting erosion in the Canadian tax base has reduced the potential revenue available from corporations through income taxation. This has resulted in governments levying greater amounts of other taxes, such as capital taxes on corporations, thereby impeding prospects for job creation in Canada.

Impediments to Economic Growth and Job Creation

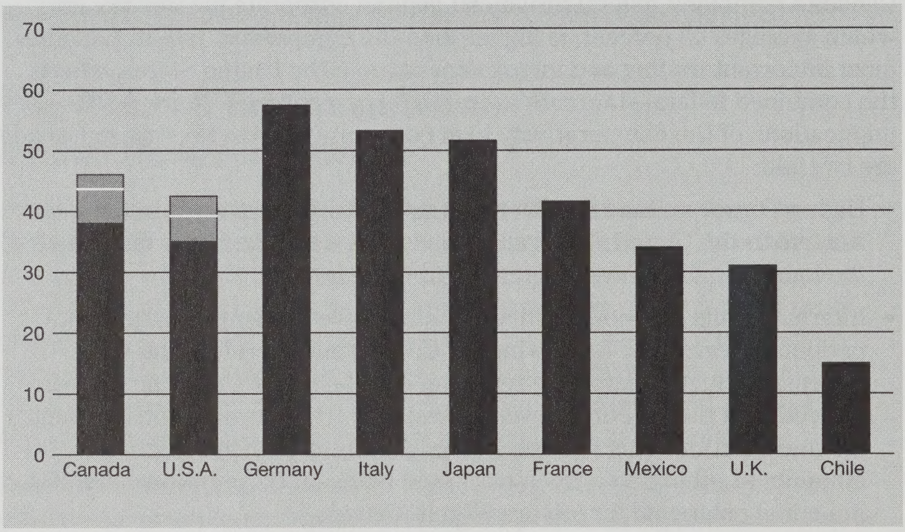
Although corporate income tax reform in the mid-1980s reduced a number of economic distortions in the tax system, several remain that result in economic inefficiency, unfairness and high compliance costs.

- Tax burdens vary substantially across different types of business activities, creating economic inefficiency, unfairness, and greater costs of compliance and administration.
- Important service industries, including utilities, wholesale trade and other services, are taxed more highly than other sectors of the Canadian economy and in comparison to similar activities in the United States (see Chart 2).

Growing Reliance on Profit-insensitive Taxes

In 1995, Canadian business paid only $19 billion in corporate income tax but over three times that amount in profit-insensitive taxes. Over the past two decades, these profit-insensitive taxes have grown substantially, increasing more quickly than corporate income tax revenues, particularly in the case of provincial and local government taxes. Some of these taxes are directly related to benefits received by the corporation, but many of these profit-

Chart 1
Maximum Corporate Income Tax Rates – 1997



Note:

Shaded top portion of bars for Canada and U.S. indicates range of combined federal-provincial/state rates due to variation among provincial/state rates.
The white line within this range indicates the weighted average level of the combined federal-provincial/state rates.

insensitive taxes are unrelated to specific benefits or costs of publicly provided programs and can result in economic inefficiency and unfairness among businesses.

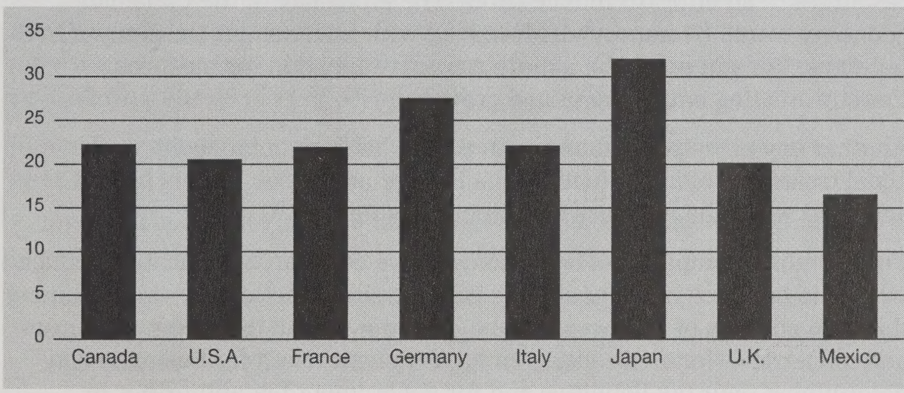
The Committee's Overall Perspective: Neutrality with Internationally Competitive Tax Rates

As we reviewed each of the business taxes, it became clear to the Committee that the pursuit of one overall principle for business taxation – neutrality together with internationally competitive tax rates – is consistent with the aims of job creation and economic growth, simplification and fairness. With neutrality, the total tax paid on income earned from different

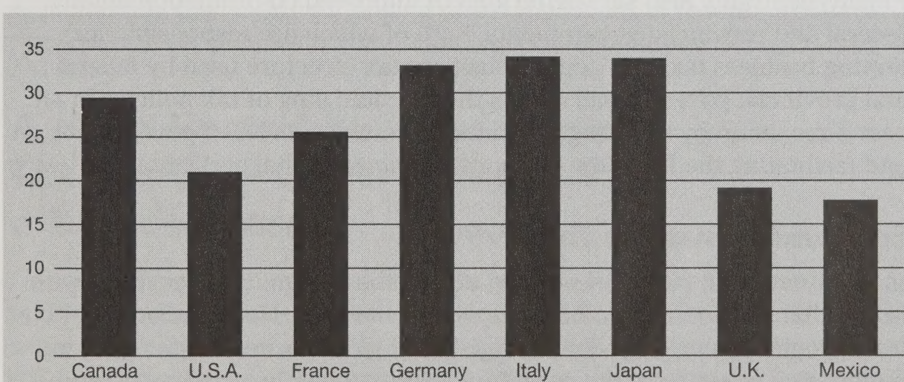
Chart 2

Effective Tax Rates on Marginal Investments
G7 countries plus Mexico (1995)

Manufacturing Industry



Service Industries



Notes:

The measure of tax rates shown in the chart includes the impact of corporate income statutory tax rates (covered by Chart 1) and other provisions which affect the incentive to undertake new investment such as depreciation allowances for tax purposes, treatment of inventories, and capital taxes.

In this Chart, effective tax rates are calculated relative to gross-of-tax rates of return on capital.

business activities is similar so the decisions of businesses are largely unaffected by the tax system. Tax rates are kept as low and competitive as possible by being applied to the broadest possible base.

Neutrality encourages businesses and entrepreneurs to pursue profitable opportunities that will make Canada prosper, rather than to waste resources in an effort to reduce taxes. The efficiency of the Canadian economy would be improved. Moreover, with lower and more competitive tax rates, Canada would be a more attractive location for business, thereby creating employment and growth.

Another key objective is fairness, in particular horizontal equity or the equal treatment of individuals in similar circumstances. This is best achieved when the business tax structure is neutral.

Furthermore, compliance and administrative costs are significantly reduced when the business tax is neutral so that fewer distinctions are made among different sources of business income or in the overall treatment of sectors and industries. Non-neutrality creates complexity both for businesses in determining their tax liabilities and for government tax authorities in administering the tax system.

Finally, neutrality also serves the goal of improved co-ordination among federal and provincial governments, both of which are responsible for levying business taxes. A neutral business tax structure used by federal and provincial governments assists the disentangling of tax policies in an economic union by reducing interactions between levels of government and facilitating the free flow of goods, services, capital and labour.

Economic issues of the 1990s

In addition to the factors described above, the Committee was faced with issues that did not have to be dealt with in the past. These include rapid technological change in a knowledge-based global economy, the growing importance of services, the growth of international flows of capital and trade, and the trend away from producing goods to discovering, disseminating and using knowledge. Canada must take a hard look at where the new jobs are being created in our economy and ensure that the tax system is not biased against growth in those sectors.

Basic Thrusts of the Committee's Recommendations

(Summarized below are the essential elements of the Committee's recommendations. The detailed explanations of each proposed measure, its underlying rationale and its relationship to the broader themes of the Committee's conclusions are set out in the full report. As the report emphasizes, the individual recommendations should not be considered in isolation but as part of an overall package.)

In our report, we recommend measures to make the tax system more neutral by:

- lowering corporate income tax rates for business toward international norms and correspondingly broadening the tax base;
- making certain profit-insensitive taxes fall more heavily on those who derive related benefits from public programs or contribute to costs imposed on Canadians – the principle of user pay;
- reducing compliance costs and improving enforcement within the tax system; and
- facilitating the co-ordination and disentanglement of federal-provincial corporate tax policies within Canada's economic union.

A More Neutral Business Income Tax System – Lower Rates and a Broader Base

Overall, we propose a more neutral system whereby the corporate income tax rate for all industries is lowered toward international norms. At the same time we propose a number of base-broadening measures to improve efficiency and fairness. Taken together, our measures should not change the aggregate amount of taxes paid by business.

These lower rates would help make Canadian business more competitive internationally and reduce the incentives to shift income out of Canada and deductions into this country. Further, the lower rates and base broadening measures would themselves reduce the distortions and inefficiencies in the income tax system.

A Modernised Corporate Income Tax

We would broaden the corporate income tax base to make it more neutral and less distorting. We propose some reductions in research and development tax incentives, still leaving them among the most generous in the world. We recommend replacing the Atlantic Investment Tax Credit with a more cost-effective and broad-based non-tax program. We also recommend that mining and oil and gas industries should be treated in a way more comparable to other industries. We propose a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in some accelerated classes.

Our proposals would ultimately result in an average federal-provincial corporate income tax rate of 33 percent on large businesses. This would ensure that all businesses benefit from internationally competitive corporate income tax rates, not just the manufacturing and processing sector and the resource sector. We recommend a general federal rate of 20 percent. We also suggest that, with the revenues from base-broadening, the provinces could reduce their corporate income tax rates by 1 percentage point to, on average, 13 percent.

Small Canadian-owned businesses would continue to benefit from preferential federal-provincial tax rates ranging from 18 percent for those small firms with substantial payrolls to 21 percent on average for firms with no employees. The federal rate would range from 11 percent to 14 percent and the suggested provincial rate would be reduced by 1 percentage point to an average of 7 percent. The federal corporate income tax surtax would be eliminated for both large and small businesses.

We also recommend that the federal and provincial governments consider the adoption of a formal mechanism that would allow businesses to transfer losses within a corporate group. This would reduce compliance costs and result in a fairer treatment of business loss deductions.

Modifications to Rules on Taxing Outbound and Inbound Investment

Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of Canada's revenue base on the other. The Committee believes that adopting its proposals – lower corporate income tax rates competitive with those of our major competitors, offset by base broadening that includes international tax measures where appropriate – would achieve increased domestic investment and job creation, greater

fairness and better protection of Canada's domestic tax base. Specifically, with regard to international tax measures, the Committee proposes:

- a modification of our system of taxing income received by Canadian corporations from their foreign affiliates to require a higher ownership threshold to benefit from the system;
- that, with respect to income from transactions between foreign affiliates of the same Canadian taxpayer, the right to repatriate such income free of tax to Canada be limited to those affiliates fully entitled to tax treaty benefits with Canada;
- that Canadian taxpayers should no longer be able to claim a current deduction for interest expense traced to investments in foreign affiliates;
- that the ability of non-residents to shift interest expense to related Canadian business enterprises be more restricted by modifying current thin capitalization rules, and repealing the rules related to non-resident owned investment corporations; and
- that interest payable to arm's length non-residents be exempt from Canadian withholding tax, regardless of the term of the related indebtedness.

Measures to Better Integrate Corporate and Personal Taxes

The Committee favours maintaining the existing dividend tax credit to give recognition to individuals receiving dividends from Canadian corporations for the tax already paid by the corporation on its income. But to achieve greater efficiency and fairness, we recommend that the dividend tax credit be more closely tied to the actual taxes paid by the corporations through the introduction of a joint federal-provincial Corporate Distributions Tax.

We also favour retaining the current exclusion of one-quarter of capital gains from income so that capital gains and dividends are taxed at roughly the same rate and that the double taxation of corporate income is partially relieved. However, we recommend that the lifetime capital gains exemption for farm property and shares of Canadian-controlled private corporations be replaced by a new retirement saving measure that recognizes the difficulties that some farmers and owners of small businesses have in accessing the current system of tax-assisted savings for retirement.

Moving Towards the User Pay Principle

As matters of both efficiency and fairness, we believe that some taxes should be more closely related to the user pay principle. In appropriate cases, businesses should be charged at levels corresponding to the economic benefits they receive from public goods or services, or the costs that they impose on society. The key measures proposed are:

Experience-rated Employment Insurance Premiums for Employers

We recommend that the employer premiums for employment insurance be restructured so that employers who have fewer layoffs – and hence cause their workers to use the employment insurance system less than others – would pay lower premiums. Businesses would thereby be encouraged to reduce employee turnover rates in order to earn a lower contribution rate for employment insurance. We believe this proposal would significantly promote stable employment and efficiency.

Environmental Taxation

We also recommend that the federal government, after consultation with the provinces, consider restructuring the federal fuel excise tax so that it more closely corresponds to the user pay principle. The current federal excise tax on fuels is inefficient and unfair in that it levies tax on only one category of product – gasoline and other motive fuels – that affects the environment. Restructuring the federal fuel excise tax in the manner we suggest would raise the same revenue. The restructured tax would include other sources of pollutants and ensure that polluting activities by businesses – and by all Canadians – bear a more appropriate charge for the use of air, water and land.

Compliance and Enforcement

The Committee recommends several measures it believes would result in improved compliance and enforcement:

- federal and provincial governments should harmonize the structure and administration of certain business taxes – notably capital taxes – to provide significant reductions in compliance costs;
- new procedures for drafting should be adopted to improve the application and understanding of tax legislation;

- new mechanisms should be introduced to enable Revenue Canada to apply commercial practices to settle disputes and collect taxes owing;
- civil penalty provisions in the tax legislation should be expanded to apply to advisors and promoters who are grossly negligent.

Improving the Co-ordination of Federal-Provincial Tax Policies

With a shared tax field, the federal and provincial governments have a common interest in working together to achieve a harmonized and balanced tax system. With the aim of further encouraging co-operation and disentanglement, the Committee makes the following recommendations:

- federal and provincial governments should work toward using neutral common corporate income and capital tax bases;
- federal and provincial governments should extend the present federal-provincial tax collection agreement to capital taxes, and to all provinces; This would help minimize compliance costs for taxpayers and administrative costs for governments. The federal government should take active measures to better ensure the proper application of the inter-provincial allocation of the corporate income and capital tax bases;
- capital taxes, which are closely related to income taxes, should not be deductible from the corporate income tax base. This would remove an incentive for one government to expand its capital taxes, since part of the cost of the tax would no longer fall on other governments.

Our recommendations to the federal government would result in base-broadening that would benefit the provinces in terms of additional revenues. We urge the provinces to consider an offsetting reduction in corporate income and capital taxes as this base-broadening takes effect. Without a substantial level of cooperation by the federal and provincial governments concerning our recommendations, the Report's objectives will not be achieved. The Committee urges the federal government to consult with the provinces with a view to achieving a common broad approach.

The Impact of our Recommendations

Under our terms of reference, the Committee was asked to take into account fiscal constraints faced by federal and provincial governments. Accordingly, we have brought forward a balanced package of recommendations for taxing the business sector which could be implemented over a period of time in a fiscally neutral manner.

As shown in the table, our proposals would neither increase nor decrease the level of federal and provincial business taxes in a mature (post-transition) system. If the provinces also agree to implement business tax reductions financed from the revenues obtained from the base-broadening measures, then the overall package would be revenue neutral at both the federal and provincial levels.

The Committee's terms of reference required us to bring forward a package of recommendations that would raise approximately the same revenue as the existing system. This precluded us from evaluating the total level of taxes paid by Canadian business in relation to international competitiveness, or the balance between business and other taxes.

We believe that the federal government should carefully monitor the international competitiveness of Canadian business as it implements changes in the tax system. If this review indicates that the total burden of taxes on business impairs its international competitiveness, we believe that the government should consider action to reduce that burden. The objective should be to ensure that business contributes appropriately to economic growth and job creation, even if this results in some reduction in overall taxes raised from businesses.

Impact of Recommendations on Federal and Provincial Revenues

	Federal	Provincial	Total
		($ millions)	
Corporate Income Tax Rate Reduction			
Large business	-2,200	-340	-2,540
Small business	-285	-160	-445
Subtotal	-2,485	-500	-2,985
Base Broadening and Reduced Tax Credits			
International Business Income	400	250	650
Non-deductibility of Capital Taxes	375	200	575
Corporation Distributions Tax	350	175	525
Lifetime Capital Gains Exemption Replacement	275	175	450
Mining, Oil and Gas	215	130	345
Temporary Increase in Financial Institution Surtaxes	300	–	300
Research and Development	200	10	210
Capital Cost Allowance	105	60	165
Atlantic Investment Tax Credit	95	Small	95
Subtotal	2,315	1,000	3,315
Net, before other adjustments	-170	500	330
Other Adjustments			
Savings to governments as employers on EI Contributions	100	190	290
Reductions in Provincial Capital Taxes or Other Adjustments	–	-550	-550
Total	**-70**	**140**	**70**

Conclusion

The Committee believes its proposals for the business tax structure constitute a balanced package that would provide new opportunities for economic growth and job creation for Canadians. Lowering tax rates toward international norms would provide a greater incentive for business to invest and create jobs here, while also protecting the revenue base. Broader bases with low rates will also make the business tax structure more fair and efficient. We believe that this report, together with consultations that will follow, will contribute to a better business tax structure that will benefit Canadians.

Technical Committee on Business Taxation

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1 Mr. Cowan was appointed to the Technical Committee in May 1996, after the untimely death of Mr. Gerry Godsoe of Halifax, who was one of the original nine Committee members.